Annual Newsletter

THE INVESTMENT TRUST OF INDIA
LONG-SHORT EQUITY FUND

15th April 2020

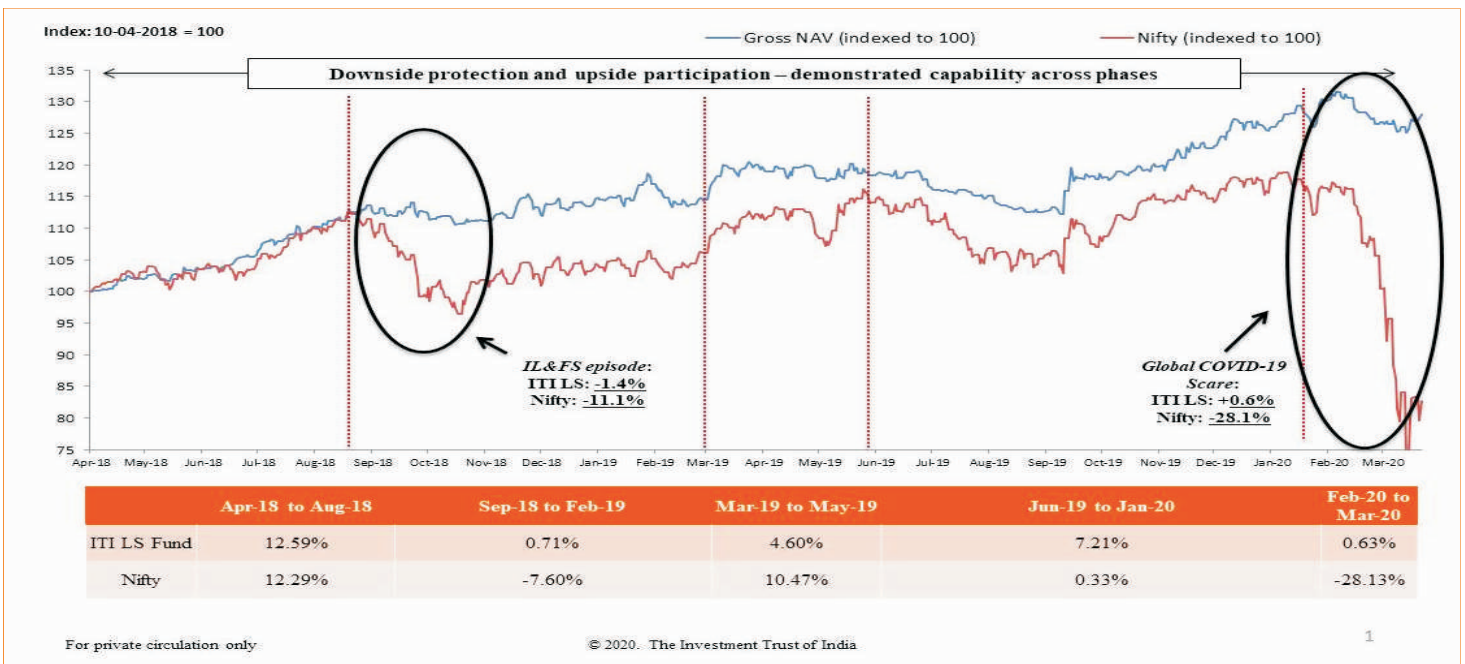
Dear Investor,

First, we hope all of you are ok and safely sheltering at home amidst the unfortunate ongoing pandemic. We trust you are taking the necessary precautions to keep you and your loved ones safe. As a firm, we want to place on record our deep gratitude to all the healthcare staff, the police force, government bodies and social workers who are combating the challenges at the front line, so that we all can be safe.

Our Dharma : Protecting downside

We are truly in extraordinary, yet unprecedented times. Indian equity markets have witnessed one of the fastest 30% declines ever during February-March 2020, as we deal with a non-business cycle driven risk. We are albeit happy to report that we have been able to protect capital during this phase (see chart below : Asymmetric returns; also see Annexure 1 for details on monthly, quarterly as well as post tax returns of the fund for FY19 and FY20).

Asymmetric Return Profile



	Apr-18 to Aug-18	Sep-18 to Feb-19	Mar-19 to May-19	Jun-19 to Jan-20	Feb-20 to Mar-20
ITI LS Fund	12.59%	0.71%	4.60%	7.21%	0.63%
Nifty	12.29%	-7.60%	10.47%	0.33%	-28.13%

We believe this ability to protect downside is a significant value add of a long-short equity fund such as ours. As can be seen from the above chart, we had similarly protected downside during the IL&FS episode decline in August and September 2018. There is a process to this ability which makes it repeatable. **To reiterate, risk management is the bedrock our fund management process.**

We believe that avoiding serious losses is a necessary precondition to achieving an attractive compounded rate of growth in wealth over a period of time. It is instructive to keep the mathematics of declines in mind : a 33% decline in the portfolio from Rs. 100 to Rs. 67, requires a 50% rise to come back to the original capital of Rs 100. Thus, it is more damaging to lose money than make it. **In our fund's case, not only have we protected capital during this decline, but also have the entire conserved capital to invest at beaten down prices.**

As stated in our fund objective, this asymmetric return profile - participating in rising markets, while protecting downside in declining ones - will help us to beat the equity indices over a full cycle, with much lower risk and much lower volatility.

Global governments and central banks to the rescue :

As we speak, the markets are bouncing back from their lows with a vigour. Of course, it is to be expected after such a sharp and quick drop in equity markets, but more importantly the trigger has been the unprecedented scale of liquidity that has been unleashed by developed market central banks and governments. The US Federal Reserve, which has been the most aggressive, is expected to increase its balance sheet from US$3.8 Trillion to almost US$10 Trillion, an increase of US$6 Trillion! (Around 30% of US GDP). This will be in conjunction with an unusually high government fiscal deficit of US$3.8 Trillion (19% of US GDP). Thus, the monetary and fiscal combined for just USA could be around US$10 Trillion or around 50% of its GDP!

Such an unprecedented scale of stimulus and at such quick speed has been warranted by the hard stop in corporate revenues due to the economic lockdown caused by the Covid-19 pandemic. The IMF estimates that global GDP will contract by 3% in 2020, its worst decline since the Great Depression of 1929. The attempt of the governments and central banks of the developed world is to protect individual and business incomes during the lockdown phase and ensure a V-shaped recovery as the pandemic recedes and business activity starts again.

It is pertinent to note, however, the intent of the central bankers globally was similar post the great financial crisis of 2008; they wanted a normal business cycle recovery along with inflation which would help them to scale back the Quantitative Easing (QE) measures. Instead, what they got was asset price inflation and a rise in debt (remember the “Everything Bubble” ?). With low or negative interest rates across the globe, market participants reached for yield and lowered their lending standards. As against the global financial crisis, where the debt was high in banks, this time it is the corporates where the debt resides (US corporate debt at over 50% of GDP is at a five-decade high). This has made the global financial system fragile. The US Fed well aware of this fragility has acted with full force to avoid a credit cycle driven economic depression.

But the question to ask is do the fresh new steps not entrench the already dysfunctional monetary policy that contributed to the original financial fragility in this system in the first place? Can it prevent a downturn due to credit cycle risks in global markets as desired? Does it not damage the free markets ability to price the true cost of risk? Does it not punish the thoughtful assessor of risk and creates a moral hazard for the reckless? Does the unleashing of such large quantities of money supply not risk the onset of hyperinflation? Will it not result in the demise of Fiat currencies? The unprecedented and truly extraordinary monetary policy moves do raise a lot of questions as to how it is shaping the world and the financial ecosystem we live in today. We would leave these interesting questions to be debated and judged by the intellectuals, although a few trends seem likely:

(1) With such a monetary and fiscal resolve to do “whatever it takes”, a Great Global Depression is likely averted.

(2) Like in the year 2013, the events are likely to revive a debate on the “Great Rotation” from bonds to equities. Note yields of most developed market treasury are close to zero. With such a large printing of currency and the risk of hyperinflation eventually, will bond investors prefer the growing coupons of equities and hence bid prices of equities higher (could this explain the sharp pull back in US markets even as the real economy is in tatters?).

(3) Expect a continuation of high free cash flows companies with a “clear earning thesis” to trade at abnormally higher valuations to the rest of the market like the pre Covid-19 era (may be more so).

(4) Expect market returns to be driven even more by macro events; drops and rises like March and April 2020 will become more frequent.

So why is it important to understand these global economic factors in the Indian context?

(1) Since the world is integrated, economic and capital markets ebb and flow in a synchronised fashion. And,

(2) Foreigners (FII's) own 40% of India's free-floating equity stock and hence global sentiments do impact our markets. Instructive to keep in mind how a US$10 billion withdrawal from Indian equities by FII's since February 2020 led to the 30% decline in our equity markets, even as Indian funds bought US$9 billion of equity.

Indian Challenges and Opportunities :

As can be seen globally, governments and central bankers are working in unison to dampen the impact of the economic lockdowns on the economy and ensure a quicker rebound when things normalise. India, however, is faced with its own set of challenges here. Even as we entered the pandemic, the Indian economy was slowing down and the overall fiscal deficit (Centre+state+off balance sheet) was pegged at over 9% of GDP. The high fiscal deficit has the effects of cannibalising the entire household savings, leading to the proverbial “crowding out” effect; as a consequence, even as the RBI reduced rates, banks were unable to transmit them to the system.

Now with the economic lockdown, not only will the governments revenues facing a sharp cut due to reduction in direct and indirect taxes, but also it will have to step up expenditure to support the economy. This is inspite of likely higher collection in oil tax revenues as taxes offset lower oil prices. Any perception of profligacy and feeling of debt trap by global rating agencies could result in a downgrade, the fear of which would restraint the government from an aggressive stimulus. Currently, India's rating is at BBB and any downgrade below this could relegate it to junk status, which could risk higher interest rates and/or a sharp depreciation of the currency.

We recognise that we are dealing with a scientific subject and a significant unknown which is the trajectory of the virus. However, how much the government needs to support the economy is dependent on when the lockdown is lifted. There is fear that even as the first lockdown is lifted, a second wave of infection could hit which could lead to another full or partial lockdown. The common wisdom is that unless there is a vaccine to cure the virus or herd immunity is acquired, fear of the virus would remain. The risk is that if the lockdowns last three months or more, the economic damage could perhaps take a year or more to repair. Thus, we would conservatively assume a U-shaped economic recovery than a V-shaped one.

Make no mistake, corporate and individual incomes will be significantly affected due to the shutdowns. Corporate earnings will be significantly dented. Even as the shutdowns are lifted, changes in buyer behaviour could wreak havoc on some businesses. Example, people are less likely to travel, visit restaurants, cinemas etc as they did pre-Covid 19. In this context, is it possible that Indian equity markets start underperforming the global markets given its lack of fiscal and monetary firepower ? While equity valuations are reasonable (Price to book of around 2x and market cap to GDP of around 50-60%), the duration of the economic challenge is what could weigh on markets.

Given our inability at this stage to narrow the range of outcomes, we think it is prudent to conserve capital and allow events to unfold. Our experience suggests that when such large macro driven events unfold, several “blowouts” or “accidents” are revealed which one could not anticipate earlier - the crash in oil prices or the challenges in the credit schemes of Indian mutual funds are examples. We would be equally happy to be surprised on the upside.

As a portfolio strategy therefore, we are keeping a light position and advocate patience. It is important to keep the stock market adage in mind “bull markets take the stairs, while bear markets take the elevator”. We therefore anticipate markets to price in the bad news, if ever that is what is to emerge, in the next two or three months. **We are looking forward to buy aggressively as the bottom out process is evident in the markets.**

Our process to generate ideas remains the same : which is to read, think and hope to have a long attention span. We consistently remind ourselves that the ability to think independently is a key skill which helps an investor see trends ahead of the market. Lastly, we keep emphasising the need to keep our investing framework simple and emphasise the use of common sense at all times.

Meanwhile, we are spending time to understand the on-the-ground realities by listening to companies and conducting our independent channel checks. Our research is focused on identifying sectors and companies which can emerge winners and losers. Clearly, there will be (i) a shift to digitisation of business (e-commerce will gain) and (ii) consolidation towards larger players with a stronger balance sheets across sectors. Example : Telecom as a sector could be a beneficiary. Meanwhile, financials (lending businesses) are likely to face severe challenges ahead. A churn in investor portfolios towards these trends is already in evidence in the Indian markets. We will keep you posted on our findings.

We would like to end on a ring of optimism. After all, optimism is a key trait of successful investors in equity markets. The developed markets, including China, are burdened with debt and have ageing demographics; factors that don't bode well for future demand and growth. India, on the other hand, has an average age of less than 30 years and could emerge as the world's growth engine. Secondly, as the Covid-19 crisis settles across the world, developed nations are expressing their desire to diversify away from China; India could be a large potential beneficiary of this trend. Lastly, India is known to bring in the most difficult reforms when faced with a crisis. So there could be a silver lining to this crisis and India could eventually emerge structurally a much sharper, growth oriented economy !

Please remain careful and stay safe !

Sincerely,

Rajesh Bhatia
Managing Director & CIO
ITI Long Short Equity Fund

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ANNEXURE

Performance

Quarterly:

Gross Returns	Q1 FY 19*	Q2 FY 19	Q3 FY 19	Q4 FY 19	Q1 FY 20	Q2 FY 20	Q3 FY 20	Q4 FY 20	Since Inception*
ITI LS	5.32%	7.38%	0.62%	4.57%	-0.75%	-1.14%	6.64%	1.51%	26.41%
Nifty	3.00%	2.02%	-0.62%	7.00%	1.42%	-2.67%	6.05%	-29.35%	-17.35%

Monthly:

Gross Returns	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Since Inception*
ITI LS	0.21%	-1.07%	0.11%	-2.64%	-2.81%	4.48%	1.43%	2.50%	2.57%	0.97%	0.87%	-0.33%	26.41%
Nifty	1.07%	1.49%	-1.12%	-5.69%	-0.85%	4.09%	3.51%	1.50%	0.93%	-1.70%	-6.36%	-23.25%	-17.35%

Gross Returns	Apr-18*	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19
ITI LS	2.32%	1.36%	1.55%	4.68%	2.03%	0.55%	-1.66%	3.00%	-0.66%	1.83%	-2.51%	5.34%
Nifty	3.24%	-0.03%	-0.20%	5.99%	2.85%	-6.42%	-4.98%	4.72%	-0.13%	-0.29%	-0.36%	7.70%

*From 11th April, 2018;
Fund returns are after expenses, before management fees and taxes

Annual (post fees and taxes):

Gross Returns	FY19	FY20	Since Inception*
ITI LS	13.9%	-0.8%	13.0%
Nifty	11.7%	-26.0%	-17.3%

*From 11th April, 2018;
Fund returns are after expenses, management fees and taxes